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# REPLY

# WHAT'S IN A NAME? INCOME, CONSUMPTION, AND THE SOURCES OF TAX COMPLEXITY

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Professor Paul has provided a nuanced analysis of complexity in the tax law.[1] She may well be right about the tangles that would emerge, should the country seek to travel the consumption tax route. I fear, however, that her treatment of problems that could arise under a variety of circumstances may distract from the potential for simplification offered by the consumption—and not by the income—approach to tax design. After reading her Article, I remain convinced that the consumption approach wins the simplicity contest.

Professor Paul identifies three sources of complexity: the quest for equity, the financial stakes in reducing uncertainty, and interest group politics.[2] My basic position is that, unless one *defines* equity in terms of Haig-Simons income, consumption tax approaches are superior on all three counts. To be sure, *any* system can be made complex (in all three dimensions that Professor Paul identifies). In our political process, complexity is a likely outcome in any regulatory regime (need I mention pensions, financial institutions, environmental regulation?). The consumption tax approach does not promise nirvana. But I think that once the approach is understood, it is possible and even likely that simplicity *relative* to current law would result.

In my view, the theoretical contrast between consumption and income as guiding ideas for a tax base has diverted attention from how actual taxing schemes that fit under one or the other rubric

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1. *See* Deborah L. Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151 (1997).

2. *See id.* at 163-80.

might actually work. Take as an example a value-added tax of the consumption type implemented by the subtraction method.[3] In such a system, each business is taxed on the difference between gross sales and purchases from other businesses. If all businesses are taxed at the same rate, interbusiness transactions net out, so the tax base in the aggregate equals the sales by the consolidated business sector to households. This is a measure of national consumption—one reason for applying the term "consumption type" to this tax. A well-known feature of such a tax is that purchases of capital goods from other businesses are immediately deducted (that is, expensed) by the acquiring business. Changing the accounting for such purchases to an income basis—substituting depreciation allowances for expensing—converts a consumption tax into an income tax. It seems to me that this is not a very dramatic difference.

One reason why this is made out to be a dramatic difference is that economists have taught us that under an income tax, "capital income" is fully taxed, whereas under the consumption tax, it is completely free of tax. Exempting income from capital would seem, surely, to be a regressive approach. Yet if we study the actual systems I described, we see that the difference is that the taxpaying business gets an acceleration of a certain deduction. The great fortunes are not made on early versus late deductions. They are made by inventing Microsoft DOS or monopolizing the cigarette industry. These sources of great wealth are taxed alike under either the consumption-type or the income-type value added tax. The labels, "consumption" and "capital income" (the rest being, presumably, "labor income"), divert commentators from looking at what actually is occurring. The valid point is that in principle, the difference between income and consumption taxes is the treatment of the risk-free reward to waiting.[4] Whether or not one agrees with me

3. *See id.* at 185.

4. I say "in principle" because in practice, income taxes are such bad approximations of the ideal. Consider, for example, the taxation of risk-free interest with even very modest inflation. Professor Paul notes that the federal income tax (along with the state income taxes) does tax inflationary gains. *See id.* at 191 & nn.146-47. The inflation problem is much more problematic than is suggested by Professor Paul's discussion. The federal tax also allows deduction of the inflation premium in interest paid. As a result, in a time of inflation, the inconsistency between the treatment of different forms of financial returns is likely to permit sufficiently clever taxpayers to arbitrage away their "capital income." For example, they can borrow to buy assets that appreciate. It is true that the appreciation is overtaxed (because of failure to correct the basis for inflation) but the interest deduction may be so exaggerated that it overcompensates. Inflation is a killer of an income tax that does not use mark-to-market accounting.

that the timing of consumption should not affect a person's discounted tax burden, this treatment does not amount to much.[5]

There are, to be sure, consumption type systems that would markedly change the distribution of the tax burdens. Replacing the income tax with a proportional sales tax, with no adjustment in transfers or programs such as the earned income tax credit, would be just such a major change. But the same comment would apply if the replacement were an income-type value-added tax.

I agree with Professor Paul that the equity issue drives the debate. As we both see it, the equity challenge to all tax systems is to attach the right burdens to the right people. I have generally argued that the right people to bear relatively more of the tax burden are those who are fortunately endowed with skills and opportunities. Identifying those people is very difficult, but it also is my view that income and consumption taxes discriminate among people in about the same way in the most important dimensions. Where they differ, in differently discriminating among people who differ in their taste for the timing of consumption or the timing of their endowed earnings, it seems to me the income tax is inferior.[6]

Professor Paul gives a good example of the failure of a consumption tax to discriminate correctly between two people who have the same opportunities when she notes that "a person who has the opportunity to earn $100 but chooses not to earn the $100 has the ability to pay tax on $100 (because she has the ability to earn the $100), but she does not have any consumption because she does not in fact earn the $100 and consume it."[7] It is unclear why Professor Paul does not emphasize that consumption and income-type taxes are equally deficient on this score because the hypothetical person also would have no income. To me, this is the central defect of both income and consumption taxes but hardly a particular shortcoming of

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5. This point is slowly being absorbed into the conventional wisdom. *See* Joseph Bankman & Thomas Griffith, *Is the Debate Between an Income Tax and a Consumption Tax a Debate About Risk? Does It Matter?*, 47 TAX L. REV. 377, 407 (1992); David F. Bradford, *Consumption Taxes: Some Fundamental Transition Issues*, *in* FRONTIERS OF TAX REFORM 123, 128 (Michael J. Boskin ed., 1996); William M. Gentry & R. Glenn Hubbard, *Distributional Implications of Introducing a Broad-Based Consumption Tax*, *in* 11 TAX POLICY AND THE ECONOMY 1, 1-2 (1997).

6. As Professor Kaplow has pointed out, the discrimination under a conventional Haig-Simons income tax between two individuals, alike in the discounted value but differing in the timing of their earnings, is due to the failure to account consistently for human and other capital. *See* Louis Kaplow, *Human Capital Under an Ideal Income Tax*, 80 VA. L. REV. 1477, 1490-94 (1994).

7. Paul, *supra* note 1, at 194.

consumption taxes *relative* to income taxes, the bone of contention here.

In my view, if one asks not whether consumption taxes will produce greater simplicity than income taxes, but instead whether the consumption approach offers significant advantages if one is setting out to design a fair and simpler system, however one may choose to label it, the answer remains, "yes."

The distractions in this quest are, by and large, of two types. One set of distractions relates to adjustments that are often made within proportional taxes to make them more progressive. For example, Professor Paul notes that a "common approach in the case of a retail sales tax or a value added tax is to exclude necessities, such as food and prescription drugs, from the tax base."[8] It is hard to understand why this admittedly common source of complexity is necessary in the first place in a system that permits, through transfers, a wide variety of superior methods of vertical adjustment.[9] As a replacement for the existing income tax, an *indirect* income tax would suffer from the same shortcomings and attract the same sorts of remedies.

As pointed out by Professor Paul,[10] two consumption type reforms are capable of satisfying the not-much-change-in-overall-progressivity requirement: a direct tax (epitomized by the Cash Flow Tax proposal spelled out in *Blueprints for Basic Tax Reform*[11]), and a proportional indirect consumption tax (such as a value-added tax) accompanied by a major change in the transfer programs, such as expansion of the earned income credit. In the latter category, I put the Flat Tax or the (more progressive) variant that I have dubbed the

8. *Id.* at 195.

9. Professor Paul applies the positive-sounding adjective "flexible" to the option to impose different taxes on different goods under retail sales and credit-and-invoice value-added taxes. *See id.* at 186. Note that this flexibility, which may have something to do with the political success of these forms of tax, is arguably undesirable on all the criteria usually accepted by policy analysts. It is ineffective as a means of adjusting for equity, and utterly unnecessary when there is a personal tax and transfer system. It is a huge source of complexity and compliance costs. It is wonderful for playing interest group games. Least certainly, but probably, it is a source of extra deadweight loss relative to a uniform rate. (Whether this is so depends on a lot of cross-elasticities about which we have virtually no evidence.)

10. *See id.* at 181.

11. DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM (1977). This source is also available, in convenient format, with index and with a preface by me containing commentary that benefits from hindsight, as DAVID F. BRADFORD ET AL., BLUEPRINTS FOR BASIC TAX REFORM (2d ed. 1984). For further discussion of the cash flow tax, see generally DAVID F. BRADFORD, UNTANGLING THE INCOME TAX 75-99, 316-20 (1986) [hereinafter BRADFORD, UNTANGLING THE INCOME TAX].

"X Tax."[12] Either of these approaches would permit progressivity similar to that of the present system. Whether they would satisfy other criteria, including other equity criteria is, to be sure, debatable. But they should indicate the direction in which to look when encountering progressivity concerns while pursuing the consumption approach.[13]

The second set of distractions relates to various measurement problems that might arise under a consumption approach that satisfies the requirement of progressivity. Examples in Professor Paul's Article include the treatment of owner-occupied housing and consumer durables,[14] measurement of consumer surplus and nonmarket consumption, including leisure,[15] distinctions based on the timing of cash flows,[16] distinctions between real and financial transactions,[17] distinctions between domestic and foreign location of consumption,[18] and distinctions between services (including education) and goods.[19]

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12. The "X tax" scheme is in the class of "two-tiered cash-flow taxes" described in BRADFORD, UNTANGLING THE INCOME TAX, *supra* note 11, at 59-74, 329-34.

13. A brief comment, cutting across the income-consumption issue, on simplicity aspects of the choice between the indirect-with-adjustment and the direct approaches: as Professor Paul notes, in this choice there are forces working in both directions. *See* Paul, *supra* note 1, at 181-87. There exists a striking example, however, of the potential for simplicity and low compliance costs in a system with sufficiently clear conceptual underpinning: the social security payroll tax. *See* 42 U.S.C. §§ 302-433 (1994). It is interesting that an instrument second in revenue only to the individual income tax, with a rate of over 15%, seems so relatively free of complexity and low in compliance cost.

14. *See* Paul, *supra* note 1, at 199.

15. *See id.* at 200.

16. *See id.* at 202.

17. *See id.* at 205-06.

18. *See id.* at 206-07. In a personal consumption (or income) tax framework, the distinction would never arise. In an indirect tax framework, the matter is a little subtler. Ignoring for the moment cross-border shopping (tourism), enforcement problems, and transition, the two approaches (origin versus destination principles) have to be essentially equivalent, since trade surpluses equal trade deficits in discounted value. Aside from appearances, which are important politically, the border adjustment question, as I see it, involves transition and a trade-off between two contending administrative approaches. First, with no adjustment (sales to abroad are taxed, purchases from abroad are deducted), there is no need to police the border, but transfer pricing problems are a nightmare. Second, with adjustment, there is no transfer pricing problem, but you have to check at the border, and goods purchased abroad as a tourist escape U.S. tax. The latter problems are diminished if tax regimes and rates are similar in different countries.

In a true individual Haig-Simons income tax, the situation would be comparable to the *Blueprints* Cash Flow Tax. *See* DEPARTMENT OF THE TREASURY, *supra* note 11, at 9. If an entity-level tax (e.g., value-added tax or corporation income tax) is employed, I do not think that one can seriously argue that the treatment of international transactions is not much easier under a consumption tax than under an income tax.

19. *See* Paul, *supra* note 1, at 207-08.

I believe that for these, and for most of the other examples raised in the Article, there are relatively simple responses. Rather than take them up *seriatim*, I would emphasize two general points to keep in mind while thinking about such issues. First, if, as is generally accepted, an income tax is supposed to be based on the sum of a person's consumption and change in wealth during a period, any question about how to interpret the consumption concept should be about the same in both systems. So, for example, an ideal income tax would measure the yield obtained from an owner-occupied home, in the form of consumption services and accruing wealth. An ideal consumption tax would measure only the consumption piece.[20]

Second, and more important, the object of the game is *not* to measure and tax consumption, or income, for that matter. The object is to impose tax burdens on the right people—to achieve equity—in a simple manner. That is why I usually speak of consumption *approaches* or the consumption *approach* rather than consumption taxes. Thus, if one accepts as a good outcome the result of treating owner-occupied housing services as consumption and taxing them currently, a system that—while not measuring and taxing such consumption currently—nevertheless imposed the same burden, understood as the same discounted tax liability, is fine.[21]

Suppose, for the sake of argument, that my equity argument is accepted *and* that substance, rather than form, is to guide our design of instruments. (So, for example, we are not put off if someone who receives a payment of interest does not at that point send a check to the Treasury, provided we are convinced that person bears an appropriate share of the tax burden.) Since it is conceded that many

20. It is ironic that Professor Paul singles out as a potential source of complexity in a consumption tax the need to measure the consumption element of owner-occupied housing, and the similar consumption yield of other consumer durables. *See id.* at 199. Whereas exactly the same problem exists in an income tax but is insoluble, one of the nice things about consumption approaches is that they get this right, in the sense of consistency with the treatment of other assets. This (especially owner-occupied housing) is generally taken as one of the major *advantages* of the consumption over the income approach. For an extensive discussion of this point, see, for example, BRADFORD, UNTANGLING THE INCOME TAX, *supra* note 11, at 85-86.

21. This is the effect of a value-added tax applied to the purchase of housing, and of the disallowance of a deduction for purchase of a house in the *Blueprints* Cash Flow Tax. Similarly, in the *Blueprints* Cash Flow Tax, the taxpayer is allowed to choose between qualified account and tax pre-payment treatments of financial assets and liabilities. *See* DEPARTMENT OF THE TREASURY, *supra* note 11, at 18, 121-22. The choice affects the timing of tax payments but not their discounted value. If the tax rate varies over time, this present value equivalence breaks down, but *Blueprints* argued that the self-averaging effect of allowing the taxpayer to choose between treatments was one of the strengths of the proposed system. *See id.* at 123-24.

sources of complexity are the same in the income and consumption approaches (such as dealing with the family and the business-personal boundary), what *are* the relative advantages of the consumption approach?

I believe that the main advantages arise from (1) the possibility of virtually eliminating the taxation of financial transactions from the personal tax and greatly simplifying their treatment in the business tax; and (2) making feasible the correction of the tax base for inflation. Although these may seem to be minor, technical matters, consider just three examples of matters in which these advantages arise: new financial instruments, retirement savings, and capital gains.

*New financial instruments.* The U.S. economy is extraordinarily dynamic. Innovation and flexibility are its hallmarks. Nowhere has innovation proceeded more rapidly than in financial markets. The ingenuity of Wall Street's rocket scientists is legendary. The tax system relates to these developments in two ways. First, much of the ingenuity is directed toward obtaining the best tax results in connection with any particular economic activity. Indeed, some of the ingenuity is directed to making profit at the expense of the U.S. Treasury. The tax rules also obstruct the accomplishment of new financial arrangements.[22]

*Retirement savings.* The second example is retirement savings.[23]

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22. David Hariton provides a superb illustration of the problems, taking as an illustration of the state of the law the steps involved in advising a taxpayer who owns low-basis stock and borrows identical stock and sells it short. *See* David P. Hariton, *The Tax Treatment of Hedged Positions in Stock: What Hath Technical Analysis Wrought?*, 50 TAX L. REV. 803, 804-09 (1995). This would seem to be a pretty straightforward, if not exactly everyday transaction. Having first established that any number of possible complicating characteristics of the taxpayer do not apply (the taxpayer is not a controlled foreign corporation, for example), Hariton goes on for many pages discussing options that the tax advisor must resolve, rules that may or may not apply, apparent inconsistencies, and so on, and concludes there is no unambiguously correct advice. *See id.*

23. When I started as an assistant professor at Princeton University a long time ago, there was a retirement plan that called for contributions that were graded according to age, one rate up to age 30, another to age 40, and the highest rate over age 50. At some point Princeton changed its plan, but let existing faculty elect to continue on the "old plan." The new plan was more generous than the old plan up to age 50, and less generous after age 50. I chose to stay on the old plan. By the time I reached age 50, most faculty members were on the new plan. Those of us who had survived so long at the University were, perforce, in the senior and hence better-paid ranks of the faculty. At that point it was determined that the old plan discriminated in favor of better-paid employees, and was therefore ineligible for favorable tax treatment. We had to switch to the new plan, notwithstanding the fact that we had just reached the point where our persistence in the old plan was about to pay off! Believe it or not, my objective here is not to plead for relief from this injustice, but simply to call attention to one of the most complex areas of

Practitioners know how difficult it is to assure compliance with the law, and how much talent is devoted to designing plans that fit within the regulatory constraints. Yet the contractual relations between employer and employees serve a large variety of economic functions. As with financial innovation, we are, on the one hand, wasting resources figuring out how to make the arrangements that most exploit the tax advantages, while staying within the law, and on the other hand, tying the hands of our employers and employees in reaching the most effective compensation arrangements.

*Capital gains.* It used to be said that half of the business of a tax accountant or lawyer was converting ordinary income to capital gains. The other half was converting capital losses to ordinary income losses. This was especially true when the difference in the rate of tax applied to the two types of income was larger than it has been until recently. But the difference has widened again. And in any case, because of the necessity to limit capital losses, the rules that distinguish the income according to its ordinary or capital gain "character" have continued in force and account for many inches of tax law books. In view of the interminable controversy about capital gains taxation, it need hardly be said that the rules involve much more than fees for accountants and lawyers, but enter into many aspects of the business and financial life of the country, with costly effect.

All three of these examples have in common that they are sources of great complexity and impose costs on the U.S. economy. These costs are borne not only by the businesses and individuals who must directly comply with the rules in question. Like the costs of banking laws or securities laws or telecommunications regulations, the costs that they impose are spread throughout the economy, striking workers and consumers at all income levels. These three examples also have in common that they are hard to fix within an income approach, given the lack of acceptance and impracticality of universal mark-to-market accounting.

A third common element shared by these three examples is that they are easily dealt with in a consumption tax approach.

Not just any old consumption tax will translate into a simpler (or otherwise better) tax law. An ill-informed application of the ideas can lead to something like the European value-added taxes or the state sales taxes.[24] These may be simpler than the U.S. income tax,

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the tax law.

24. *Cf.* Paul, *supra* note 1, at 195 nn.163-64 (comparing complexity under a U.S. consumption tax to complexity under European sales taxes); *id.* at 195 n.165 (comparing

but they are hardly encouraging models for us to follow. On the other hand, a consumption approach to tax design grounded in a clear grasp of the underlying logic does, indeed, hold the potential for a much simpler law. Professor Paul has added to our knowledge of the complexity-producing processes. As far as the consumption-income base choice is concerned, I hope that readers will take away from her account a catalogue of traps for the unwary rather than a conclusion that the consumption approach cannot be deployed to advantage in the quest for a simpler tax system.

complexity under a U.S. consumption tax to complexity under state sales tax regimes); *id.* at 206-07 (describing difficulties that state sales tax regimes encounter regarding taxation of goods purchased outside but consumed within the state); *id.* at 207-08 (suggesting that the difficulties that states have experienced with teasing apart goods and services also would be problematic for a federal consumption tax).